U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT





FEDERAL HOUSING COMMISSIONER

March 11, 2011

MORTGAGEE LETTER 2011-15

TO: ALL FHA APPROVED MULTIFAMILY MORTGAGEES

SUBJECT: Revision to Procedures for Partial Payment of Claims of Section 232 Mortgages

A. Purpose

The Office of Healthcare Programs (OHP) is in the process of preparing/updating the internal guidance regarding Partial Payments of Claim (PPCs) so that OHP will have guidance specifically applicable to the Section 232 Program. (Guidance on this topic with respect to other FHA programs has historically been contained in HUD Housing Handbook 4350.1, Chapter 14.) This mortgagee letter addresses and immediately implements policies with respect to Partial Payments of Claim (PPC), as they relate to the Section 232 program. This mortgagee letter does not address notes for which assignment to the Secretary has already been completed and which are thus HUD-held.

This Notice complements Mortgagee Letter 87-9 which allows for the waiver of prepayment penalties and lockout provisions in mortgages to avoid a mortgage insurance claim. Properties approved for a PPC are deemed to have complied with all terms of Mortgagee Letter 87-9.

As permitted by statute, Section 232 projects will be eligible for PPCs (12 U.S.C. Section 1735f-19, "Partial payment of claims on defaulted mortgages and in connection with mortgage restructuring"). In 1997, 12 U.S.C. Section 1735f-19 was amended to encompass mortgages on healthcare facilities. Current regulatory and handbook provisions, however, predate those amendments and were not revised to reflect the statutory change. Thus, the regulatory provision addressing PPCs (24 CFR 207.258b) does not specifically reference healthcare facilities. Additionally, 24 CFR 232.251 and Housing Handbook 4350.1 REV-1, Chapter 14 both specify that Section 232 projects are not eligible for PPCs (paragraph 14-2). Since PPCs on Section 232 projects are now statutorily permitted, this Mortgagee Letter sets out guidance for implementing that statutory authority. Specific terms related to the above procedural matters are detailed under B - H below.

B. Background

The current regulations for a Partial Payment of Claim, found at 24 CFR 207.258b, are made inapplicable to the Section 232 Program by 24 CFR 232.251. The

provisions at 24 CFR 207.258b do, however, provide some useful guidance with respect to implementing a Section 232 PPC policy and thus are utilized, in part, in this Mortgagee Letter.

When a lender of a loan on a Section 232 project becomes eligible to file an insurance claim and to assign the mortgage to the Federal Housing Administration (FHA) Commissioner ("the Commissioner") pursuant to 24 CFR 207.258, the Commissioner may request the lender, in lieu of assignment, to accept a partial payment of the claim under the mortgage insurance contract and to recast the mortgage, under such terms and conditions as the Commissioner may determine. The Commissioner may request the lender to participate in a partial payment of claim in lieu of assignment only after a determination that partial payment would be less costly to the Federal government than other reasonable alternatives for maintaining the project. This determination shall be based upon the findings listed below and such other findings as the Commissioner deems appropriate:

- 1. The lender is entitled, after a default as defined in 24 CFR 207.255, to assign the mortgage in exchange for the payment of insurance benefits.
- 2. The relief resulting from partial payment when considered with other resources available to the project would be sufficient to restore the financial viability of the project. In evaluating financial viability, the Department will evaluate the adequacy of the debt service coverage ratio, which would generally be expected to be at or above 1.2, after allowing for the mortgage insurance payment. The Department will also consider the size of the requested PPC as a percentage of the current outstanding mortgage, seeking to keep the PPC no larger than essential and not exceeding 50 percent. (*Also, see* Item 2 in Section C herein.)
- 3. The project is or can (at reasonable cost) be made physically sound. (*Also*, *see* Item 3 in Section C herein.)
- 4. The current or proposed operator of the facility is satisfactory to the Commissioner, as demonstrated by past experience in operating similar type health care facilities and by state regulatory performance. (*Also, see* Item 4 in Section C herein.)
- 5. The default under the insured mortgage was beyond the control of the borrower and/or operator, or in the case of a Transfer of Physical Assets (TPA), the proposed borrower or operator, unless OHP determines that any borrower/operator deficiencies giving rise to the default have clearly been addressed.
- 6. The project is serving as, or potentially could serve as, a needed nursing home, intermediate care facility, or board and care home, or assisted living facility.
- 7. The property covered by the mortgage is free and clear of all liens other than the insured first mortgage.

- 8. The lender has voluntarily agreed to accept a PPC under the mortgage insurance contract and to recast the remaining mortgage amount under terms and conditions prescribed by the Commissioner.
- 9. The borrower has agreed to repay to the Commissioner an amount equal to the partial payment, with the obligation secured by a second mortgage on the project containing terms and conditions prescribed by the Commissioner. The terms of the second mortgage will be determined on a case-by-case basis to ensure that the estimated project income will be sufficient to cover estimated operating expenses and debt service on the recast insured mortgage.
- 10. For a partial payment of claim, the mortgagor has made a net capital contribution equal to 5% or more of the original mortgage to fund operating shortfalls since final endorsement (for a nonprofit, including its in-kind services acceptable to OHP). The consecutive timeframe for this determination commences at final endorsement, and then continues up to the date of initial default. This calculation period can be adjusted at HUD's sole discretion. If a TPA will be involved, then contributions to be brought to the project at closing by the acquiring mortgagor can be included in this determination.
- 11. The mortgagor has remitted all net cash (i.e., the cash remaining after the project has paid all of its operating expenses) to the lender between the date of default and the date of closing on the PPC. If the operator is a different entity than the mortgagor, then this requirement is expanded, and the operator must also submit to the mortgagor all net cash derived from the operation between the date of default and closing of the PPC.

C. Applicant's Proposal

The borrower's formal proposal is to be submitted to the OHP Account Executive servicing the particular mortgage loan. (If a Transfer of Physical Assets (TPA) is anticipated, then the applicant must concurrently submit a TPA application in accordance with OHP requirements.) The PPC proposal must demonstrate that all of the matters set forth in Section B, above, will be met, and should include the following:

- 1. Cover letter stating the parameters and conditions of the borrower's request. The borrower must provide:
 - i. The amount of a recast first mortgage that is supportable by cash flow (broken down into the two amounts: principal and deferred interest).
 - ii. An anticipated closing date, generally within 4 months from the date of the request.
 - iii. A discussion of the problem(s) that caused the default including a history of the project and its decline.

- iv. Steps that have been taken to overcome both past and present problem(s), including without limitation cost containment (staffing, payroll, administrative costs, dietary, etc., as applicable), revenue issues (marketing, payer mix, case mix), and survey/Special Focus Facility matters.
- v. A discussion (referencing related exhibits) of how the PPC request addresses all of the matters set forth in Section B above. *See* Paragraphs 2 through 6 of this Section C for additional details and materials/exhibits needed with respect to some of those matters.
- vi. If any part of the submission requires a waiver of provisions set forth herein, a discussion of what waiver is needed and why it is in HUD's best interest to waive the provision.
- 2. In addressing the restoration of financial viability (Item 2 in Section B above), copies of current year budget, most recent interim statement, and the last three fiscal years' audited financial statements for the borrower and operator must be submitted. If audited statements had not been required for the operator, then operator-certified statements may be substituted. Included in these must be statements detailing accounts payable aging, account receivable aging, and census/rent roll. In presenting this financial data, the applicant must demonstrate that working capital (i.e., Current Assets minus Current Liabilities) is positive. All accounts over 30 days must be reviewed to ensure that they are collectible and/or payment terms are such that a demand from the vendor would not jeopardize the project. If a borrower has a payable owed to a vendor in an IOI relationship with the borrower, then the borrower can either lend non-project funds to the project (repayable only out of the borrower's share of future surplus cash) or the vendor can agree to accept in payment a note that is only repayable out of the borrower's share of surplus cash. A reasonable and well-supported request to allow a deficit position will be considered on a case-by-case basis, however, recent payments to identity-of-interest vendors over trade payables will not be looked at favorably. The financial statements must also be used to develop and provide projections for 10 years post PPC closing. Projections should detail trending assumptions, and any changes in operations that result in deviations from historical results. Current and projected census should be discussed. The discussion of restoration to financial viability should also discuss the extent to which the surplus cash mortgage note resulting from the PPC is anticipated to be paid down over time. Addressing financial viability should include providing adequate evidence of the reasonableness of census, revenue and expense projections. Doing so may involve getting an appraisal, PCNA and/or market study/plan.
- 3. In addressing physical condition (Item 3 in Section B above), a discussion with exhibits concerning the property's condition and adequacy of the replacement reserve account and projected reserve contributions for 10

- years post PPC closing must be included. This discussion must include the status of corrective action taken or to be taken to address physical deficiencies identified in the most recent HUD physical inspection report. OHP may require a Project Comprehensive Needs Assessment (PCNA) if, in light of a property's reserve for replacement, evidence suggests the property's physical condition is concerning.
- 4. In addressing the adequacy of the current operator (or proposed operator if a TPA is anticipated to occur after the PPC) (Item 4 in Section B above), evidence is to be submitted of the subject facility's performance in the most recent three years of surveys/assessments by the state regulatory agency. If there are any outstanding deficiencies identified by the state regulatory authorities or the Center for Medicare and Medicaid Services, then the discussion must include how those matters are being addressed. If a new operator is being proposed, then this section should also incorporate by reference the information being provided about that entity's experience and performance in the separate application for change of operator.
- 5. A statement of net borrower contributions (for addressing Item 10 in Section B above). Borrower contributions must have been in the form of cash, however for a non-profit, in-kind services may be considered. Accrued but unpaid Identity of Interest (IOI) expenses (management, ground lease, or similar) generally may not be considered, but if requested and approved by HUD, these unpaid fees must be converted to a note and future (post PPC closing) fees must be treated similarly for years in which surplus cash is negative. A certified statement by an independent public accountant or a certified public accountant must be provided showing all contributions, advances and repayments to the borrower. This statement shall cover the period since final endorsement (or later agreed-upon date pursuant to item 10 in Section B above) and shall include, but is not limited to, the following:
 - i.Contributions made
 - ii. Distributions taken
 - iii.Advances made
 - iv.Advances repaid
 - v.In determining net contribution, borrower is prohibited from including contributions made to offset advances taken but not repaid by an IOI operator.

Note that, post PPC, advances used in the calculation above can only be repaid from the borrower's share of future surplus cash. If a TPA application is being submitted, then cash contributions of the purchaser may be included, and the supporting data in the TPA should be referenced.

6. Additional information to support the PPC request, including but not limited to letters reflecting local support, how the property is providing

or will provide needed residential healthcare, and any other related information. This may include, without limitation, an appraisal, PCNA and/or market study.

D. Recast 1st Mortgage Note Rate

The First Mortgage Note will be modified to reflect:

- 1. A reduced principal mortgage (as a result of the PPC).
- 2. An interest rate at 125 basis points over the 10 year Treasury rate on the day a terms letter is offered.
- 3. The maturity date, which is the original maturity date unless an extended date within statutory authority has been agreed upon.
- 4. Monthly payments are re-amortized based on 1, 2, and 3.

If requested by the lender, the First Mortgage Note may include a restriction on prepayment for the purpose of enhancing the marketability of the new GNMA Mortgage-Backed Security. Any prepayment restriction must be in accordance with Mortgagee Letter 87-9.

E. Project Comprehensive Needs Assessment (PCNA)

A Project Comprehensive Needs Assessment (PCNA) may be required when OHP determines that a property's physical condition must be further assessed in order to evaluate the feasibility of the proposal. Circumstances giving rise to the need for a PCNA may include, without limitation:

- 1. When the initial endorsement is greater than 10 years from submission.
- 2. When reserves are less than \$250/unit.

F. Borrower Contribution

HUD has historically required a borrower's contribution at the 5% level with respect to PPCs in other FHA programs, and this will remain for the 232 program. If a TPA is involved, then contributions to be brought to the project at closing by the acquiring mortgagor can be included in the calculation.

G. Second Mortgage Note

Subject to any requirements for additional borrower cash or excess project cash, HUD will include in the Second Mortgage Note the amount of interest computed since the date of delinquency based on the actual number of days in a 365- or 366-day year. Late fees accrued since the last payment or any other costs to close cannot be included in the transaction or paid by the project in the future.

The terms of the Second Mortgage Note will be as follows:

- 1. An interest rate equal to the applicable Federal Rate for the month of closing.
- 2. Maturity date co-terminus with the First Mortgage Note.
- 3. A "due-on-sale, refinance, or termination" provision.
- 4. As long as the Second Mortgage Note is held by HUD, a service charge calculated at 0.5 percent annually based on the unpaid principal balance of the Second Mortgage Note must be paid to HUD monthly.
- 5. The minimum annual payment on the Second Mortgage Note will be 75 percent of annual surplus cash (or 50 percent when the PPC is contemporaneous with a change in ownership and control of the mortgaged asset) as specified in the Regulatory Agreement between the Secretary of Housing and Urban Development and the project borrower, together with the applicable HUD Regulations and administrative requirements. The payment of surplus cash to be applied to the second mortgage note payment is due within 10 days of the required filing of the Annual Financial Statement. Borrower's share shall be twenty-five (25) percent (or 50 percent under the circumstances above) and remain available to meet project obligations, including authorized distributions. The minimum annual payment will be applied towards interest first and then principal.
- 6. Consistent with the Second Mortgage Note, in the event, and when, the project is operated by an entity that is legally distinct from but in identify of interest with the borrower, the *minimum* annual payment on the Second Mortgage Note will be 100 percent of annual surplus cash as defined in the Regulatory Agreement. Additionally, in that event, the borrower must collect from the Operator/Lessee a lease payment equaling or exceeding all payments required of the Purchaser for payment of all principal, interest, escrow and fees on any amortizing notes, plus 75 percent (75%) of the Operator/Lessee's net operating income from the Project (or 50 percent when the PPC is contemporaneous with a change in ownership and control of the mortgaged asset). Before calculating that rent, no payments to the Operator/Lessee or any related party, beyond 5% (five percent) of gross revenue (as a management fee) may be deducted. The borrower must accomplish any amendment to the lease necessary to effectuate this rental calculation prior to the completion of the PPC transaction.
- 7. Language prohibiting successors and assigns of the beneficiary of the Second Mortgage Note from imposing property insurance requirements that exceed the original principal balance contained in the First Mortgage Note or are in addition to those required by the First Mortgage Note Holder so long as the First Mortgage Note is insured by the Secretary of Housing and Urban Development.
- 8. HUD has the right to sell the Second Mortgage Note. If HUD sells the Second Mortgage Note, the borrower and Operator/Lessee are required

to submit annual financial statements to the Second Mortgage Note Holder in the same form as submitted to HUD or other format acceptable to the note holder.

H. Other Terms and Conditions of PPC Transaction

- 1. If Identity-of-Interest expenditures have been included as a Borrower's Contribution in calculating eligibility for a PPC, then a requirement that those expenditures cannot be taken or must be re-deposited for any year in which surplus cash is negative (not to exceed the amount of the negative surplus cash). The redeposit or accrual can only be repaid from the borrower's share of surplus cash in future years.
- 2. The monthly deposit to the Reserve for Replacement Account (RFR) will resume with the first payment of the recast First Mortgage Note. (Previous deposits will not have to be made up, unless the reserve balance has been determined to be inadequate).
- 3. All escrows, such as tax, hazard insurance and mortgage insurance premium (MIP) shall be fully funded at closing.
- 4. Under no circumstances may changes be made to the documents reviewed other than to conform to the terms and conditions of this approval, without HUD's specific authorization. HUD's Office of General Counsel may modify the documents to confirm to local legal requirements.
- 5. If the insured First Mortgage Note is repaid, the borrower must establish and maintain continued funding of all escrows required by the First Mortgage Note until the Second Mortgage Note is repaid in full.
- 6. Project operating income may not be used to pay financing fees, attorney fees, consultant fees, other professional fees, or any other costs of the restructuring transaction. The borrower's share of future surplus cash may be used for these purposes only if available for distribution in accordance with HUD regulatory requirements and applicable policy guidelines.
- 7. Cash held in suspense by the lender will be allowed by HUD to be used at closing to pay reasonable closing attorney fees, title and recording fees, escrow shortages and interest for the remainder of the closing month. The PPC will not be increased if project cash is insufficient to cover these costs.
- 8. HUD will include in the Second Mortgage Note the amount of interest computed since the date of delinquency based on the actual number of days in a 365- or 366-day year. The lender cannot collect more interest from the project than paid by HUD.
- 9. Sources and Uses of Funds Statement for this refinancing may not show disbursements of funds to the borrowers as funds are prohibited from being disbursed to the borrowers in a PPC transaction.
- 10. No funds may be paid to identity-of-interest persons or entities. The Sources and Uses of Funds Statement must also be signed by the

- Borrower or representative below the following statement: "Warning: It is a crime to knowingly make false statements to a Federal Agency. Penalties upon conviction can include a fine and imprisonment. For details, See Title 18, U.S. Code 1001 and 1010."
- 11. The first mortgage loan documents in a PPC shall provide that the borrower and the servicer/lender of the first mortgage loan must provide notices and documentation to the second note holder upon the occurrence of events that could affect the value and position of the second mortgage lender such as: full or partial payment on the first mortgage loan, events of default on the first mortgage loan, declaration of bankruptcy by the borrower, and any documentation related to a bankruptcy or any foreclosure action.
- 12. In the event the First Mortgage Note is prepaid and there is no additional HUD-insured debt on the project, the borrower will furnish HUD and the Second Mortgage Note Holder audited annual financial statements until the Second Mortgage Note is satisfied.
- 13. The borrower may not incur additional debt without the prior written consent of HUD, Second Mortgage Note Holder and any separate or additional note holder.
- 14. The Second Mortgage Note Holder (subject to the rights of the first mortgage lender) has the right to foreclose on the security interest in the net cash flow perfected by filing of a UCC-1 Financing Statement, in the event of a default on the Second Mortgage Note.
- 15. After the closing of the PPC transaction, the mortgagor and operator shall each be required to file annual financial statements (and more frequent financial statements when requested) consistent with their new regulatory agreements and riders thereto that will be required and executed as part of the PPC transaction.
- 16. In cases where a TPA is envisioned, a completed TPA application must be presented to OHP at the time of PPC approval request submission.

Questions relating to this ML should be directed to John Hartung, Supervisory Account Executive, at (314) 539-6333, Division of Residential Care Facilities, Office of Healthcare Programs.

/s/

David H. Stevens Assistant Secretary for Housing-Federal Housing Commissioner